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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re: LEEWARD HOTELS, L.P., an Arizona Limited Partnership, Debtor.	In Proceedings Under Chapter 11 Case No. B-99-09162 ECF-GBN **OBJECTION OF SECURED LENDER TO DEBTOR'S AMENDED PLAN OF REORGANIZATION DATED JANUARY 28, 2000** **Date of Hearing: June 2, 2000** **Time of Hearing: 9:00 a.m.**

LASALLE NATIONAL BANK, in its capacity as Trustee for the registered holders of DLJ Mortgage Acceptance Corporation, Commercial Mortgage Passthrough Certificates, Series 1997-CF1, by and through its Servicer, Lennar Partners, Inc. (the "Secured Lender") hereby objects to the confirmation of the "Amended Plan Of Reorganization" dated January 28, 2000 (the "Amended Plan") by LEEWARD HOTELS, L.P., debtor and debtor-in-possession in this case (the "Debtor").

Reduced to its essentials, the Amended Plan is the closing act in William Kilburg's orchestrated acquisition of overencumbered hotels for no "at-risk" capital for the purpose of having a captive client for his wholly owned (and newly formed) hotel management company. Mr. Kilburg has nothing at stake in this endeavor, and no risk of loss should this ill-conceived endeavor fail. The Secured Lender objects to the Amended Plan on the following ten (10) bases:

1. § 1129(a)(1), (2)—Non-Compliance With The Bankruptcy Code. The Amended Plan and the Debtor do not comply with Bankruptcy Code § 1129(a)(1), (2) in that: (a) the Amended Plan violates Bankruptcy Code § 363 and controlling Ninth Circuit law by not including the Secured Lender's cash collateral in the Secured Claims; (b) the Amended Plan impermissibly voids some of the Secured Lender's liens; (c) the Amended Plan improperly separately classifies the unsecured claim of the Secured Lender from the unsecured trade claims; (d) the Amended Plan improperly subordinates the unsecured claim of the Secured Lender to the unsecured trade claims; and (e) the Amended Plan improperly restricts the Secured Lender's credit bid rights under Bankruptcy Code § 363(k). *See* pages 11-17, *et seq.*

2. § 1129(a)(3)—Lack Of Good Faith. The Amended Plan is not proposed in good faith because: (a) it is being pursued for the economic benefit of insiders at the expense of, and risk to, the Secured Lender; (b) the Debtor was an entity formed on the veritable eve of bankruptcy for the purpose of acquiring the hotels and placing them into a bankruptcy and providing an insider entity with a captive client for an above market management contract; and (c) the Debtor and its principals have no "at-risk" equity or capital. *See* pages 17-19, *et seq.*

3. § 1129(a)(5)(A)(ii)—Continuation Of Kilburg's Involvement Is Not In The Best Interests Of Creditors. The Amended Plan's continuation of Kilburg Hotels, LLC as the general partner of the Reorganized Debtor is not in the best interests of the creditors. *See* pages 19-20, *et seq.*

4. § 1129(a)(7)—The Secured Lender Would Receive More In A Liquidation. The Secured Lender would receive more in the liquidation of the Debtor than it is receiving under the Amended Plan. *See* pages 20-21, *et seq.*

5. § 1129(a)(11)—The Amended Plan Is Not Feasible. The Amended Plan is not feasible and will likely result in the liquidation of the assets of the Reorganized Debtor to the prejudice of the Secured Lender. *See* pages 21-23, *et seq.*

6. § 1129(b)(1)—The Amended Plan Discriminates Unfairly. The Amended Plan's treatment of both the Secured Lender's secured claims (Classes 2N-1 through 2N-10) and the unsecured claims (Class 3B) is unfairly discriminatory. *See* pages 23, 27-28, *et seq.*

7. § 1129(b)(1)—The Amended Plan Is Not Fair And Equitable. The Amended Plan's amortization and balloon payment feature places all the economic risk of failure on the Secured Lender for the benefit of insiders, equityholders and certain unsecured creditors, and is not fair and equitable. *See* pages 23-26, *et seq.*

8. § 1129(b)(2)(A)—The Amended Plan Does Not Comply With The Cramdown Requirements As To The Secured Lender's Secured Claims. The Amended Plan violates § 1129(b)(2)(A) because: (a) the Secured Lender's lien on its cash collateral is not being preserved in violation of § 1129(b)(2)(A)(i)(I); (b) the Amended Plan ignores the Secured Lender's junior lien position on the Abilene Holiday Inn and Leavenworth hotels; and (c) the amortization, interest rate and balloon payment feature of the Amended Plan do not provide the Secured Lender with the present value of the secured claims in violation of § 1129(b)(2)(A)(i)(II). *See* pages 28-30, *et seq.*

9. § 1129(b)(2)(A)—The Amended Plan Fails To Preserve The Secured Lender's Rights Under § 363(k). The Amended Plan, through its Release Price mechanism, fails to preserve the Secured Lender's rights under § 363(k) in violation of § 1129(b)(2)(A)(ii). *See* pages 31-32, *et seq.*

10. § 1129(b)(2)(B)—The Amended Plan Violates The Absolute Priority Rule. The Amended Plan violates § 1129(b)(2)(B) because: (a) it does not provide the Secured Lender's unsecured claims with the present value of the full amount of such claim; (b) the Secured Lender has rejected the Amended Plan in its unsecured claim class; and (c) the general and limited partners of the Debtor are retaining their equity interests in the Reorganized Debtor for no new value. *See* pages 28-30, 32-39, *et seq.*

This Objection is supported by the attached Memorandum Of Points And Authorities, the exhibits referenced therein, the record before this Court and the record to be made at the confirmation hearing, all of which are incorporated by this reference herein.

RESPECTFULLY SUBMITTED this 28th day of April, 2000.

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MEMORANDUM OF POINTS AND AUTHORITIES

I. FACTUAL AND PROCEDURAL BACKGROUND.

1.1 Acquisition Of The Prior Partnerships. In January, 1999, William Kilburg and his wife (the "Kilburgs"), though Kilburg Hotels, LLC, the general partner of the Debtor, through a convoluted acquisition trail, acquired the ownership interests in twelve (12) limited partnerships, each of which owned one hotel (the "Prior Partnerships"). The Kilburgs acquired their interests in the Prior Partnerships for no at risk capital.

1.2 Formation Of The Debtor. Kilburg formed this Debtor entity in February, 1999 for the very purpose of consolidating the ownership interests in the 12 hotels held by the Prior Partnerships and putting them into bankruptcy.

1.3 Acquisition By Debtor Of The Hotels. The Kilburgs used their control of the Prior Partnerships to cause the Prior Partnerships to convey the 12 hotels into the Debtor, which conveyances occurred in late March/early April, 1999. The Debtor paid no money for the hotels, but instead gave the Prior Partnerships interests in the Debtor. Hence, the Prior Partnerships are the limited partners of this Debtor.

1.4 Encumbered Hotels. All of the 12 hotels were fully leveraged at the time of their acquisition by the Debtor in March/April, 1999. Of the 12 hotels, ten (10) were (and are) encumbered by the Secured Lender—the Abilene Holiday Inn; the Abilene Ramada Inn, the Leavenworth, Kansas hotel; the Liberty, Kansas hotel; the Olathe, Kansas hotel; the Ottawa, Kansas hotel; the Plainview, Texas hotel (collectively the "Retained Hotels"); and hotels in Dallas and Round Rock, Texas, and Las Cruces, New Mexico (collectively the "Returned Hotels"). Each of the hotels is also encumbered by a second lien to secured cross-guarantees (the "Second Liens").

1.5 Secured Lender's Claims. The Secured Lender has Secured Claims classified in Classes 2N-1 through 2N-10 (collectively the "Secured Claims")—*i.e.* one class for each of its secured

claims. In addition, the Secured Lender has an unsecured claim for its deficiency—Class 3-B (the "Unsecured Claim").

The Secured Claims total over **$20 million**. In addition, the Secured Lender's unsecured claim is over $**5.4 million**.

(a) Secured Claims (Classes 2N-1 through 2N-10). The Secured Lender's ten (10) secured claims based on current appraisals (as of March 2000) of the ten hotels are:

• Class 2N-1 (Abilene Holiday)	$ 2,700,000
• Class 2N-2 (Abilene Ramada)	2,400,000
• Class 2N-3 (Dallas)	4,000,000
• Class 2N-4 (Las Cruces)	1,200,000
• Class 2N-5 (Leavenworth)	1,400,000
• Class 2N-6 (Liberty)	1,700,000
• Class 2N-7 (Olathe)	2,735,000 (§ 1111(b)(2))
• Class 2N-8 (Ottawa)	1,458,000 (§ 1111(b)(2))
• Class 2N-9 (Plainview)	1,600,000
• Class 2N-10 (Round Rock)	900,000
Total:	**$20,093,000** [1]

(b) Unsecured Claims (Class 3-B). The Unsecured Claim of the Secured Lender is over **$5.4 million**.[2]

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[1] There are currently valuation issues outstanding to determine the specific total secured claims and unsecured claims. These estimates are based on appraised values as of March 2000. These calculations are rounded, and do not take into account unpaid real property taxes ahead of the Secured Lender's first lien positions. These amounts also do not take into account the cash collateral amounts being held which will be added to the allowed secured claims. *See In re Ambanc La Mesa ltd. Partnership*, 115 F.3d 650, 654 (9th Cir. 1996). Finally, these amounts do not include any prepayment or yield maintenance charges, all of which are expressly reserved.

[2] This is calculated as follows:

• Dallas Deficiency (2N-3)	386,000
• Round Rock Deficiency (2N-10)	1,704,000
• Las Cruces Deficiency (2N-4)	2,030,000
• Abilene Ramada Unsecured Deficiency (2N-2)	135,000
• Liberty Unsecured Deficiency (2N-6)	953,000
Total:	**$5,877,000**

From this amount, a total of $444,000 is deducted, attributable to the 2nd lien portion credits taken as part of the Secured Claim for Abilene Holiday Inn ($244,000) and Leavenworth ($200,000), yielding an unsecured claim of **$5,433,000**.

The Secured Lender, with all its claims, constitute over 80% of the total claims against this Debtor.

II. OVERVIEW OF THE PLAN.

The Amended Plan provides essentially as follows:

2.1 Returned Hotels (Classes 2N-3, 4 and 10). The Secured Lender will get back the Returned Hotels (subject to, in the aggregate, over $100,500.00 in unpaid and delinquent real property taxes). *See* Amended Plan at 10 and 12. The three claims secured by those hotels are about $10.1 million. Based on current appraisals, the amount of the credit against those claims is $6.1 million, leaving a Class 3B unsecured claim of over $4 million.[3] While the Amended Plan makes no provision for payment of the over $100,000.00 in senior unpaid real property tax claims on any of the three Returned Hotels (because the Secured Lender must pay those senior claims), the Amended Plan also credits the full value of the Returned Hotels against the Secured Lender's debts. It is an excellent example, from the Debtor's perspective, of "heads the Debtor wins; tails the Secured Lender loses."

2.2 Retained Hotels (Classes 2N-1, 2, 5, 6, 7, 8 and 9). As to the seven Retained Hotels, the Amended Plan (at pages 9-12) proposes the following:

(a) Interest Only. Interest only on the allowed secured claims at 9.75% for the first two years. The Debtor projects the total allowed secured claims at $11.9 million, which is directly inconsistent with the values of the Retained Hotels as acknowledged in the Disclosure Statement. [4]

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[3] Calculated as follows:

	Debt	Realty Taxes	(FMV-3/00)	Deficiency
• Dallas (2N-3)	$4,344,000	42,400	(4,000,000)	386,400
• Las Cruces (2N-4)	3,207,169	23,300	(1,200,000)	2,030,469
• Round Rock (2N-10)	2,568,700	34,844	(900,000)	1,703,544
			Total:	**$4,120,413**

[4] The Debtor estimated the total Allowed Secured Claims of the Secured Lender at approximately $11.98 million. Based on the market values and impact of the elections made under § 1111(b)(2), the actual aggregate allowed secured claim

(b) Amortization. In years 3 through 7, principal will be paid based on a 22.5 year amortization schedule, with interest at 9.75%. Not surprisingly, at this amortization schedule ***less than 10% of the principal of the debt is paid through the seven years of the plan***.

(c) Balloon Payment. On December 31, 2007, the entire balance of the allowed secured claims (estimated by the Debtor at over $10.8 million, or by the Debtor's own estimates, over 90.5% of the aggregate allowed secured claims) will be paid pursuant to a hoped-for and wholly speculative sale or refinance of the Retained Hotels.

(d) Sales For Release Prices. Finally, at any time after the effective date (assumed to be June, 2000), the Reorganized Debtor will have the right to sell any of the Retained Hotels. The Secured Creditor will not have any ability to credit bid its secured claims under Bankruptcy Code § 363(k). *See* Amended Plan at 15:9-12.

2.3 Unsecured Claims (Class 3-B). The Amended Plan proposes to pay the Secured Lender's Class 3B unsecured claim[5] from "Net Cash Flows." While this term is nowhere defined,[6] from the projections attached to the Disclosure Statement it appears to be the money left over after payment of operational expenses (including payment of a management fee to an insider entity, Kilburg Management). The Unsecured Claim is to be paid interest at the lower of 6% or the federal judgment rate. There are two (2) noteworthy aspects of this treatment:

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for the Retained Hotels is **over $13.9 million**. Moreover, the allowed secured claims must be increased by the amount of cash collateral of the Secured Lender being held by the Debtor. *See In re Ambanc La Mesa Ltd. Partnership,* 115 F.3d at 654.

[5] The Debtor estimates the Class 3B claim at $3.2 million, not at over $5.4 million. The Debtor is able to accomplish this magic by artificially inflating the credit to the Class 2N-3, 4 and 10 claims by: (1) artificial values for the Returned Hotels; and (2) providing no offset for over $100,000.00 in senior realty taxes that the Secured Lender will need to pay once the Returned Hotels are returned. *See* note 3, *supra*.

[6] "Net Cash Flow" is defined in the Amended Plan by reference to page 24 of the Disclosure Statement, which interestingly does not define "Net Cash Flow." In fact, "Net Cash Flow" is not defined anywhere in the Amended Plan or the Disclosure Statement.

(a) Subordination. Other unsecured trade creditors (Class 3A) get paid from Net Cash Flows before any payment is made on the Secured Lender's Class 3B Claim. By the Debtor's own estimates, of the $3.2 million Class 3B Claim, under its projected operations there will be $1.5 million (a little less than 50%) left to be paid by the December 31, 2007 balloon payment. *See* Disclosure Statement, Exhibit "I". Of course, based on the actual unsecured claim of $5.4 million there will be over $3.9 million payable on December 31, 2007.

(b) Discrimination. The Debtor anticipates it will recover a preference of $550,000.00 from the Secured Lender. If the Debtor prevails, however, the Secured Lender will not be entitled to share in any distributions of that money, all of which will go to pay other unsecured creditors in Classes 3D and 3E. *See* Amended Plan at 13.

2.4 Equity Interests. The Amended Plan provides that the existing general partners and limited partners will retain their equity interests in the Debtor. *See* Amended Plan at 13. They will receive no distributions until all claims have been paid in full.

2.5 Post-Confirmation Management. The Retained Hotels will all be managed by Kilburg Management (wholly owned by the Kilburgs) for a fee of 3.5% of revenues and an accounting fee of $1,500.00/month/Retained Hotel. *See* Amended Plan at 13. Under the Debtor's projections, in the seven years of anticipated postconfirmation operation, Kilburg Management will receive over $2.3 million in management fees and over $1 million in accounting fees. *See* Exhibit "H" to the Disclosure Statement.[7]

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[7] According to Exhibit "H" to the Disclosure Statement, Kilburg Management will be paid as follows just from the seven Retained Hotels:

	2000	2001	2002	2003	2004	2005	2006	2007	Totals
Mgmt. Fee	$247,197	$260,598	$272,546	$284,136	$293,510	$305,892	$317,090	$328,493	**$2,309,462**
Acctg. Fee	$126,000	$126,000	$126,000	$126,000	$126,000	$126,000	$126,000	$126,000	**$1,008,000**
Totals	$373,197	$386,598	$398,546	$410,136	$419,510	$431,892	$443,090	$454,493	**$3,317,462**

2.6 "Capital Infusion."

Finally, the Amended Plan provides that Kilburg Hotels (the general partner) will make a "capital infusion" in the amount of $945,000.00 for the purpose of making capital improvements to six of the seven Retained Hotels.[8] The capital infusion is, in fact, a **loan** by Best Inns **to the Debtor** (not Kilburg Hotels) pursuant to six "Best Inn Convention License Agreements" all dated as of December 30, 1999 (the "License Agreements"),[9] which: (a) is secured by a junior lien (which incidentally is a breach of the Secured Lender's loan agreement) on all the Retained Hotels (License Agreements, ¶14(G)); and (b) are cross defaulted such that in the event of a breach of any one of the License Agreements, all will be subject to termination (and repayment of the "capital infusion" as well as payment of liquidated damages).[10] This loan is guaranteed by Kilburg Hotels. *See* "Guaranty Of Payment" attached to the License Agreements.

III. LEGAL ARGUMENTS.

3.1 Burden Of Proof.

It is axiomatic that the Debtor, as the proponent of the Amended Plan, has the burden of proof in showing that all of the requirements for confirmation set forth in Bankruptcy Code § 1129 are met. *See In re Briscoe Enterprises, Ltd.*, 994 F.2d 1160 (5th Cir. 1993). In the Ninth Circuit the Debtor must prove by a preponderance of the evidence that: (a) the Amended Plan satisfies all thirteen requirements of the confirmation provisions; or (b) that the only condition not satisfied is the requirement that all impaired classes accept the Amended Plan; and, if so (c) that the Amended Plan satisfies the cramdown alternative, which requires that the Amended Plan not discriminate unfairly against objecting impaired

[8] For some reason, the Abilene Ramada hotel will not get any capital renovations from this fund.

[9] The payments are "Financial Incentives," and are paid to the Debtor, not Kilburg Hotels. *See* License Agreements at 14(B) and (C), p. 20.

[10] *See* License Agreements at ¶¶14(C), (E) and 10(D).

classes and is fair and equitable towards each objecting class. *See In re Ambanc La Mesa Ltd. Partnership*, 115 F.3d 650, 653 (9th Cir. 1997).

The Debtor fails to meet its burden on all counts. First, the Secured Lenders have rejected the Amended Plan in Classes 2N-1 through 2N-10 and 3B, and indeed filed their own competing plan of reorganization. Second, as explained in detail below the Amended Plan is not proposed in good faith, is not feasible, does not comply with the Bankruptcy Code, unfairly discriminates against the Secured Lender, and is inequitable.

3.2 Neither The Amended Plan Nor The Debtor Comply With Bankruptcy Code § 1129(a)(1), (2).

Bankruptcy Code § 1129(a) provides in pertinent part as follows:

> The court shall confirm a plan only if all of the following requirements are met:
>
> (1) The plan complies with the applicable provisions of this title.
>
> (2) The proponent of the plan complies with the applicable provisions of this title.

Bankruptcy Code § 1129(a)(1), (2).

In this case, neither the Amended Plan nor the Debtor, as that plan's proponent, comply with the applicable provisions of the Bankruptcy Code, as follows:

(a) The Amended Plan Fails To Account For The Secured Lender's Cash Collateral. The Amended Plan fails to include any provision for the inclusion of the Secured Lender's cash collateral in its allowed secured claim. The Debtor has previously admitted in the "Stipulated Interim Order Regarding Cash Collateral" dated April 10, 2000, that all cash generated by the Secured Lender's hotels held by the estate is the Secured Lender's cash collateral, either as a result of the Secured Lender's liens or

pursuant to the adequate protection provisions of Bankruptcy Code § 361 by the granting of postpetition liens on all such revenues.

In the Ninth Circuit, courts have held that the value of a secured creditor's claim, for the purposes of confirmation, must include the market value of the real property **plus the amount of the accumulated cash collateral**. *See In re Ambanc La Mesa Ltd. Partnership*, 115 F.3d at 654 (emphasis added).

As such, the Debtor must tell the Secured Lender, by each Class (*i.e.* Classes 2N-1 through 2N-10) how much cash collateral is held per hotel, and the Secured Lender's allowed secured claim must include that amount. The Debtor's Amended Plan fails to provide for either of these requirements. The Amended Plan is, as a matter of controlling law, not confirmable.

(b) The Amended Plan Impermissibly Voids the Second Lender's Second Liens on Certain Retained Hotels. In order to provide for the Debtor's "capital infusion" the Amended Plan impermissibly allows Best Inns to have a second position lien on the Retained Hotels—indeed, the second lien is a required condition to the Debtor getting this "capital infusion." By doing so, the Amended Plan attempts to void the Secured Lender's already validly existing second liens on the Retained Hotels contained in Classes 2N-1, 2N-5, and 2N-9. See "Appendix Of Exhibits Related To Various Pleadings" filed on August 3, 1999. This is improper pursuant to controlling Ninth Circuit law. *See In re Commercial Western Finance Corp.*, 761 F.2d 1329 (9th Cir. 1985) (plan cannot void a secured creditor's lien; debtor must initiate an adversary proceeding).

(c) The Amended Plan Violates Bankruptcy Code § 1122. The Amended Plan contains no less than six (6) separate classes of unsecured claims.[11] There is no reasonable basis to separately classify the Secured Lender's Unsecured Claim other than to gerrymander the vote such that the Debtor might be able to: (1) impermissibly create an impaired accepting class by neutralizing the Secured Lender's rejection that would otherwise cause the unsecured creditors class to be a rejection;[12] and (2) to allow the Debtor to improperly subordinate the Secured Lender's claim to the trade creditors (discussed in subsection (c), below) and unfairly discriminate against such claims.

Such classification is improper. First, the "one clear rule" is that a debtor cannot "classify similar claims differently in order to gerrymander an affirmative vote on a plan of reorganization." *See, In re Tucson Self-Storage, Inc.*, 166 B.R. 892, 897 (9th Cir. BAP 1994); *citing, In re Greystone III Joint Venture,* 995 F.2d 1274, 1279 (5th Cir. 1991).

Second, it is well settled in the Ninth Circuit that the segregation of unsecured trade creditors' claims from unsecured deficiency claims of secured creditors in order to obtain an accepting class is impermissible. There must be some other permissible purpose such as a business or economic justification, legal distinction of the unsecured claims, or administrative convenience that supports the separate classification. *See, In re Tucson Self-Storage, Inc.*, 166 B.R. 892 (9th Cir. BAP 1994) (The Court found that absent

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[11] Those amounts as per the Debtor's estimates are:

Class 3A	-	Unsecured Trade Claims ($600,000)
Class 3B	-	Secured Lender's Unsecured Claims ($3-4 million)
Class 3C	-	GMAC Unsecured Claim ($0)
Class 3D	-	Rejection Claims ($71,000)
Class 3E	-	Abandoned Hotel Claims ($446,000)
Class 3F	-	Samoth ($2.1 million)

[12] If the Debtor's estimates are correct (which they are not), all the Class 3 Claims total approximately $5.9 million. The Secured Lender's acknowledged Unsecured Claim of $3.1 million constitutes over 52% of the amount of total claims, making an acceptance by that class legally impossible under Bankruptcy Code § 1126(c).

legitimate business or economic justification for the separate classification of the unsecured claims, other than the fact that one classification was based upon unsecured trade debt and the other unsecured classifications based upon deficiency, the claims were otherwise similarly situated and could not be separately classified.).

As should come as no surprise, in this case the Debtor fails to offer a legitimate purpose for separate classification of the Secured Lender's unsecured claims. The rationale for this failure is simple — there is no legitimate reason. The Debtor is seeking a way to gerrymander the voting process (which is not allowable and should not be countenanced by the Court), and also needs separate classification to implement a *de facto* (and discriminatory) subordination of those claims.

(d) The Amended Plan Improperly Subordinates The Secured Lender's Class 3-B Claim In Violation Of Bankruptcy Code § 510. Under the Amended Plan there is a de facto subordination of both the secured and unsecured claims of the Secured Lender to the other unsecured creditors. The Class 3A unsecured trade creditors will share in operational cash flows after the interest only payments are made on the secured debt, and the Secured Lender's unsecured Class 3B claim won't be paid anything until the Class 3A claims are paid in full, with interest. In addition, even assuming the Secured Lender has to pay a preference amount back, it also does not get any of that money back until the unsecured claims in Classes 3D and 3E are paid in full.

When analyzing subordination under Section 510 of the Bankruptcy Code, the courts have consistently held that any attempt to "effectively" subordinate the claims of one group of unsecured creditors so as to create an unauthorized priority within a class of general unsecured creditors is improper in the absence of inequitable conduct by the subordinated unsecured creditors. *See In re Saybrook Mfg. Co.*, 963 F.2d 1490, 1495-96

(11th Cir. 1992) ("Section 507 of the Bankruptcy Code fixes the priority order of claims and expenses against the bankruptcy estate. Creditors within a given class are to be treated equally, and bankruptcy courts may not create their own rules of superpriority within a given class"). This reasoning was reinforced by the Supreme Court in its holding regarding tax penalty claims. The Supreme Court rejected equitable subordination of similarly situated claims (even in separate classes) on a categorical basis. Instead, the Supreme Court requires the court to look to the "individual equities" of the situation. *See U.S. v. Noland*, 116 S. Ct. 1524 (1996); *See also U.S. v. Reorganized CF & I Fabricators of Utah, Inc.*, 116 S. Ct. 2106 (1996).

The Amended Plan allows for Class 3A unsecured creditors to be paid in full before the Secured Lender's Class 3B unsecured claim is paid anything at all. There is no real assurance that the Secured Lender's unsecured claim will be repaid at all, let alone be paid in full as those unsecured creditors who are prioritized in payment before them will be. Indeed, over $3 million of the Secured Lender's Class 3B claim will have to await the hoped-for and highly speculative "sale or refinance" in December 2007. This result is impermissible.

One Court hit the nail on the head when it stated that, "[b]y subordinating the claims of the remaining unsecured creditors to these [other unsecured] claims, the bankruptcy court has set up a priority within the class of general unsecured creditors . . . Therefore, because there is always the possibility that [the debtor] will not have sufficient assets to pay all unsecured creditors, it is legally improper to subordinate the claims of the remaining unsecured creditors absent inequitable conduct by them." *In re FCX, Inc.*, 60 B.R. 405, 410 (Bankr. E.D.N.C. 1986).

(e) The Amended Plan Violates The Secured Lender's Credit Bid Rights Under Bankruptcy Code § 363(k). Section 363(k) allows a lienholder to bid up to the entire amount of the lien when a sale of property out of the ordinary course of business is proposed. By being allowed to credit bid under § 363(k), the Secured Lender would be able to protect the amount of its lien in essentially the same manner as allowed under the provisions of § 1111 of the Bankruptcy Code. Section 363(k) reads:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

Subsection (b) of § 363 provides for the sale of estate property, other than in the ordinary course of business, after a notice and hearing.

The Secured Lender's right to credit bid under § 363(k) is set forth in § 1129(b)(2)(A)(ii), which requires that with respect to a class of secured claims, the plan must provide:

> for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; as set forth in § 1111(b)(1)(A).

The Ninth Circuit BAP has held that when a debtor, through its plan of reorganization, seeks to reduce the amount of its debt over time while retaining an interest in future profits arising from any subsequent sale of the estate's property, that future interest is clearly a valuable right and, thus, the actual value of the subject property is unclear. As such, "fairness requires that the [secured creditor], be allowed the full amount of any value in the property. Allowing the secured creditor to credit bid under

§ 363(k) …protect[s] the [secured creditor's] interest in the full value of the property." *See In re California Hancock, Inc.*, 88 B.R. 226 (9th Cir. BAP 1988).

Under the Amended Plan, at any time after the effective date (assumed to be June, 2000), the Reorganized Debtor will have the right to sell any of the Retained Hotels. Yet the Secured Lender will not have any ability to credit bid its secured claims under Bankruptcy Code § 363(k). *See* Amended Plan at 15:9-12. Clearly this Debtor, similar to the debtor in *California Hancock,* is hoping to retain an interest in the future profits arising from any subsequent sale of the Retained Hotels. That future interest is clearly a valuable right and, thus, the actual value of the Retained Hotels is unclear. As such, paraphrasing the Ninth Circuit BAP, "fairness requires that the Secured Lender, be allowed the full amount of any value in the Retained Hotels." In short, the Secured Lender must be given the right to credit bid.

Without allowing the Secured Lender the right to credit bid in a proposed "sale" of the property pursuant to a plan of reorganization, the Court cannot properly confirm the Amended Plan.

3.3 The Amended Plan Does Not Comply With Bankruptcy Code § 1129(a)(3) In That It Is Not Proposed In Good Faith.

Bankruptcy Code § 1129 provides in pertinent part as follows:

> The Court shall confirm a plan only if all of the following requirements are met:
>
> * * *
>
> (3) The plan has been proposed in good faith and not by any means forbidden by law.

Bankruptcy Code § 1129(a)(3).

The Amended Plan is the final act in the orchestrated drama directed by Mr. Kilburg whereby he used "OPM" ("other people's money", in the form of existing debt) to acquire hotels so his wholly owned management company can try its hand at hotel management at no risk, for a captive client, and

with only upside. If this endeavor fails, Mr. Kilburg and his myriad of entities have lost nothing—they have no money at risk, nor are they willing to put any money at risk.[13] Kilburg Management stands to make over $3 million over the life of this plan in management and accounting fees (*see* note 7, *supra*), which fees are paid before *any* creditor (secured or unsecured) receives any money. Moreover, the management contract (at 3.5% of revenues) is above-market, and Mr. Kilburg knows it. Mr. Kilburg is the only flesh and blood principal of this Debtor, the general partner, all the limited partners, the Prior Partnerships, Kilburg Management, Kilburg Employment, and two unsecured creditors. The number of hats he wears and conflicting interests he must balance is staggering.

Good faith in proposing a plan of reorganization is assessed by the bankruptcy judge and viewed under the totality of the circumstances. Good faith requires a fundamental fairness in dealing with one's creditors. *See In re Jorgensen*, 66 B.R. 104, 108-109 (9th Cir. BAP 1986). Clearly, an attempt by a debtor-in-possession to give favorable treatment to an insider is violative of § 1129(a)(3)'s good faith requirement. *See In re Barr*, 38 B.R. 323 (Bankr. E.D. Mich. 1984)(debtor in possession's attempt to retain assets and keep members of his family employed in their old business at the expense of creditors was clearly a lack of good faith). Other factors indicative of bad faith include no infusion of capital and no gain in managerial expertise. *See In re Thirtieth Place, Inc.*, 30 B.R. 503, 505 (9th Cir. BAP 1983). Finally, a plan of reorganization that serves to an unacceptable extent as a vehicle for the personal profit of "investors" and contrary to the interests of creditors are additional factors indicating bad faith. *See e.g. In re Rusty Jones, Inc.*, 110 B.R. 362, 375 (Bankr. N.D. Ill. 1990).

The bottom line is that Mr. Kilburg is proposing to benefit himself with over $3 million in combined management and accounting fees, has limited experience in managing these types of hotel properties, and offers no liquidity infusion or any of his own money in the Retained Hotels while placing

[13] The most ironic and telling indication of this is underscored by Kilburg's refusal to pay even the $10,000 per hotel legal due diligence fees for Best Inns! In the License Agreements, Kilburg Hotels was listed as an entity responsible for paying those fees, and it was stricken so only the Debtor must pay those fees. *See* License Agreement, ¶14(I) at 22.

additional debt onto an already overburdened enterprise. Yet Mr. Kilburg expects the Secured Lender, who is being held hostage by the Amended Plan, to wait for seven long years for an uncertain payment while Mr. Kilburg reaps his unearned reward immediately. The totality of these circumstances adds up to one conclusion . . . the Debtor's Amended Plan has been proposed in bad faith.

3.4 The Amended Plan's Continuation Of Kilburg's Involvement Is Not In The Best Interests Of Creditors.

Bankruptcy Code § 1129 provides in pertinent part as follows:

> The Court shall confirm a plan only if all of the following requirements are met:
>
> * * *
>
> (5) …the continuance…[as control person] of such individual is consistent with the interests of creditors and equity security holders and with public policy….

Bankruptcy Code § 1129(a)(5)(A)(ii).

Under the Amended Plan, Kilburg Hotels (Mr. Kilburg's prebankruptcy-formed entity) will continue to act as general partner for the Debtor so it can orchestrate Mr. Kilburg's wholly-owned management company's control over the Retained Hotels.

"[C]ontinued service by prior management [of Debtor] may be inconsistent with the interests of creditors, equity holders, and public policy if it directly or indirectly perpetuates incompetence, lack of discretion, inexperience, or affiliations with groups inimical to the best interests of the debtor. . ." *See In re Polytherm Industries, Inc.,* 33 B.R. 823, 829 (Bankr W.D. Wis. 1983). A debtor's attempts to assume management contracts and employ persons related to the underlying investors are factors in determining that the continued management is not in the best interests of the debtor. *See In re Rusty Jones, Inc.,* 110 B.R. at 375. (The debtor moved the Court early in the case to authorize it to assume a management contract which had been entered into with one of the debtor's nominal investors during the two-week period between the "purchase" of the debtor and the debtor's

commencement of the case. That management contract would have cost the debtor substantial sums, amounting to several hundred thousands of dollars.)

Mr. Kilburg, as the underlying investor in the Debtor, has none of his own money at risk in this enterprise. Nonetheless, he stands to gain (at the expense of and risk to the Secured Lender) above market management fees. Mr. Kilburg expects the Secured Lender to subsidize his management company's high cost management fees, charged by a recent start-up company that has nominal experience in the management of these types of properties as opposed to finding less expensive but well established hotel management groups. Mr. Kilburg's attempt to retain his control of the Retained Hotels is in direct conflict with the best interests of the Secured Lender and public policy. Accordingly, the Amended Plan fails to meet the requirements of 11 U.S.C. § 1129(a)(5).

3.5 The Secured Lender Would Receive More In An Orderly Liquidation—As Such, The Amended Plan Does Not Meet The Best Interests Of Creditors Test.

Bankruptcy Code § 1129(a) provides in pertinent part as follows:

> The Court shall confirm a plan only if all of the following requirements are met:
>
> * * *
>
> (7) With respect to each impaired class of claims…—
>
> (A) each holder of a claim…of such class—
>
> * * *
>
> (ii) will receive or retain under the plan on account of such claim…property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7 of this title on such date….

Bankruptcy Code § 1129(a)(7)(A)(ii).

As is evident from the updated appraisals for the Retained Hotels, each of these hotels has declined in value from the dates of the first valuations (in March 1999) to the updated valuations (in March 2000). These hotels are limited service, marginal hotels. The Secured Lender believes that they will continue to decline in value. They will not appreciate in value as the Debtor wildly speculates. As such, return of the hotels today would yield a greater return to the Secured Lender than will the

protracted "milking" of revenues with a potential repayment 7 years from now (with over 90% of the principal balance of the secured claim and nearly 50% of the balance of the unsecured claim left unpaid at the end of that period).

"The "best interests" concept is a cornerstone of the theoretical underpinnings of Chapter 11. It stands as an individual guaranty to each creditor that it will receive at least as much in reorganization as it would in liquidation." *See In re Sierra-Cal*, 210 B.R. 168 (Bankr. E.D. Cal. 1997), *citing* 7 Collier on Bankruptcy ¶ 1129.03[7] (Lawrence P. King *et al.* eds., 15th ed. rev. 1997). "If a prompt chapter 7 liquidation would provide a better return to particular creditors. . . than a chapter 11 reorganization, then a reorganization is inappropriate and a chapter 11 plan should not be confirmed." *In re Sierra-Cal*, 210 B.R. at 168.[14]

The Retained Hotels are suffering from continued depreciation. Each day that goes by without an orderly liquidation diminishes the Secured Lender's ability to recover the full value of its claim. The Debtor's projections for the values of the Retained Hotels are speculative at best. Given the concrete evidence in the form of recent appraisals that exists today, there is no doubt that a sale of the Retained Hotels which takes place sooner rather than later will provide a better return for the Secured Lender. The Debtor's Amended Plan is inappropriate and should not be confirmed.

3.6 <u>The Amended Plan Is Not Feasible</u>.

Bankruptcy Code § 1129 provides in pertinent part as follows:

> The Court shall confirm a plan only if all of the following requirements are met:
>
> * * *
>
> (11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless liquidation or reorganization is proposed in the plan.

Bankruptcy Code § 1129(a)(11).

The evidence at the confirmation hearing will show that the Amended Plan is not feasible. To put that evidence into context, some legal framework is appropriate.

In deciding whether a proposed Chapter 11 plan is "feasible," the Bankruptcy Court must make an independent determination as to whether the plan is workable and has a reasonable likelihood of success based upon the preponderance of the evidence. *See In re 8315 Fourth Avenue Corporation,* 172 B.R. 725, 734 (Bankr. E.D.N.Y. 1994).

Feasibility, from an operational standpoint, is considered in light of future projected cash flow probability. This inquiry begins by comparing the cashflow projections with historical performance, general economic conditions, and level of competition. *See In re Consul Restaurant Corporation,* 146 B.R. 979, 984-985 (Bankr. D. Minn. 1992) (Debtor's cash flow projections did not appear realistic given historical performance and present conditions. The recent history of operations and present economic and industry conditions indicated a substantial risk of failure of the projections, which were further aggravated by a weak liquidity position. As such, the court found that the debtor's plan of reorganization was not feasible.)

Next, the purpose of the feasibility requirement is to avoid confirmation of plans which are visionary schemes that promise creditors and equity holders more than they can deliver. *See In re 8315 Fourth Avenue Corporation,* 172 B.R. at 735. A proposed Chapter 11 plan is not feasible and cannot be confirmed where financial realities do not support the proposed plan's projections, or where projections are unreasonable. *Id.*

Feasibility (or rather the lack thereof) in this case is very important since it is the Secured Lender (which must wait patiently for 7 years for repayment) who really bears the risk of default. As set forth above, the Class 3A unsecured creditors will be paid, as will the insiders on their

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[14] The best interest of creditors' test must be met as to each rejecting creditor. Bankruptcy Code § 1129 (a)(7)(A). Here, there exists the incongruous result that the Amended Plan will meet this test for Class 3A *unsecured* creditors but not the Class 2N *secured* creditor.

management fees, all before over 90% of the Secured Lender's Secured Claims, and 50% of its unsecured claim, are paid.

3.7 The Amended Plan Discriminates Unfairly In Violation Of Bankruptcy Code § 1129(b)(1).

This plan is in a "cramdown" posture. The Secured Lender has rejected this plan with respect to Classes 2N-1 through 10, and its Class 3B Unsecured Claim. All of these claims are impaired. The Secured Lender's rejecting votes carries those classes under Bankruptcy Code § 1126(c).

As such, the requirements of Bankruptcy Code § 1129(a)(8) is not met, and the Debtor must rely on the provisions of Bankruptcy Code § 1129(b) to obtain confirmation.

Bankruptcy Code § 1129(b) provides in pertinent part as follows:

> …[I]f all of the applicable requirements of [§ 1129(a)] other than [§ 1129(a)(8)] are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of [§ 1129(a)(8)] ***if the plan does not discriminate unfairly, and is fair and equitable***, with respect to each class of claims…that is impaired under, and has not accepted, the plan.

Bankruptcy Code § 1129(b)(1) (emphasis added).

The Amended Plan's treatment of both the Secured Lender's Class 3-B Unsecured Claim and Class 2N Secured Claims is neither fair nor equitable.

(a) The Amended Plan Unfairly Shifts The Economic Risk Of Default On The Secured Lender.

To be "fair and equitable" as required for confirmation of a plan under the cramdown section, a Chapter 11 plan cannot unfairly shift the risk of the plan's failure to the creditors. The bankruptcy court must make specific findings and conclusions regarding whether a plan unfairly shifts such failure risk. *In re Monarch Beach Venture, Ltd.*, 166 B.R. 428, 436 (Bankr. C.D. Cal. 1993).

Courts reject debtors' plans that seek to distribute cash to a subordinated class while the senior subordinating class remains unpaid. "The concept of fair and equitable involves more than an application of a mechanical calculation of absolute priority based on distribution of property valued abstractly. When the proposed distribution would substantially shift the risk of failure of the plan from a junior class to a senior dissenting class for no legitimate purpose, the plan is not fair and equitable to the dissenting class." *See In re Consul Restaurant Corp.*, 146 B.R. at 979.

The Debtor's Amended Plan clearly shifts the bulk of the risk, if not all of the risk, onto the Secured Lender. First, the Debtor proposes a grossly inadequate and absurd interest rate and amortization schedule. The Amended Plan provides for "interest only" on the allowed secured claims at 9.75% for the first two years. In years 3 through 7, principal will be paid based on a 22.5-year amortization schedule, with interest at 9.75%. This amortization schedule shamelessly results in less than a 10% reduction of the principal amount of the secured debt during the seven years of the plan. On December 31, 2007, the entire balance of the allowed secured claims (estimated by the Debtor at over $10.8 million, or by the Debtor's own estimates, over 90.5% of the aggregate allowed secured claims) will have to be paid pursuant to a highly speculative sale or refinance of the Retained Hotels. If the sale or refinance fails to materialize, and the value of these hotels depreciates further, presumably the Reorganized Debtor will hand the keys to these hotels to the Secured Lender. In the interim, Class 3A unsecured creditors will have been paid in full, and the insider management company will have drained over $3 million in fees from the hotels.

Second, the Debtor proposes that other unsecured trade creditors (Class 3A) get paid from Net Cash Flows before any payment is made on the Secured Lender's Class 3B

Claim. By the Debtor's own estimates, of the $3.2 million Class 3B Claim, under its projected operations there will be $1.5 million (a little less than 50%) left to be paid by the December 31, 2007 balloon payment.

Finally, the Debtor offers no capital infusion into the hotels other than those dollars to be used to reflag six of the seven Retained Hotels. And even then, that capital infusion is in the form of a loan to be used solely for refurbishing six of the Retained Hotels, and only further adding to the debt load to be carried by an already overburdened enterprise. By providing for a cash infusion in the form of a loan, the Debtor continues to have none of its own capital at risk in the Amended Plan. It is the natural extension of Mr. Kilburg's "OPM" business strategy.

In short, the Debtor is proposing to: (1) inappropriately subordinate the Secured Lender's claims to other claims ensuring the Secured Lender is the last to be repaid; (2) offer an absurdly low interest rate given the risk to the Secured Lender; (3) provide for a virtually non-existent amortization that scarcely begins to pay down the principal owed to the Secured Lender; (4) provide a mechanism to milk over $3 million in fees over the life of the Amended Plan; and (5) ensure none of the Debtor's own money is at risk in the enterprise.

By structuring the Amended Plan in this way, the Secured Lender is the only one left in a worse position than it is in today when this house of cards eventually falls. Other unsecured creditors will have received payment, and of course Kilburg Management will have received large management fees with no fear of loss of any capital. Only the Secured Lender is vulnerable to being left with depreciated assets that leaves it in a worse position than it was in before the Amended Plan was confirmed. As one court eloquently stated, "[i]t is just this sort of attempted risk shifting that the absolute priority rule was

intended to prevent." *See In re Miami Center Associates, Ltd.*, 144 B.R. 937, 942 (Bankr. S.D. Fla. 1992).

(b) <u>The Amended Plan Is Not Fair And Equitable To The Class 3B Unsecured Claim</u>.

As stated previously, the unsecured trade creditors (Class 3A) get paid from Net Cash Flows before any payment is made on the Secured Lender's Class 3B Claim. By the Debtor's own estimates, of the $3.2 million Class 3B Claim, under its projected operations there will be $1.5 million (a little less than 50%) left to be paid by the December 31, 2007 balloon payment.

The fair and equitable standard "includes" the objective standard of the absolute priority rule, but is without limitation subject to a more subjective standard. *See In re Dollar Associates*, 172 B.R. 945, 949 (Bankr. N.D. Cal. 1994). Thus, even if the absolute priority rule or an exception is met, the Bankruptcy Court should nonetheless deny confirmation of a plan that it determines, upon the objections of a dissenting class, to be unfair and inequitable in a factual and substantive sense. *In re VIP Motor Lodge, Inc.*, 133 B.R. 41 (Bankr. D. Del. 1991)(30-year repayment schedule is not "fair and equitable" to objecting creditor.).

Under the Amended Plan the Debtor proposes to pay unsecured trade creditors prior to paying the Secured Lender's Class 3B unsecured deficiency claim. Even worse, the Secured Lender is forced to wait seven years before payment of over half of the claim. The Debtor offers no explanation of this disparate treatment of similar claims, leaving one to speculate that the Debtor is being either arbitrary and capricious or simply abusive toward the Secured Lender. In either circumstance the Court must find that the Debtor's treatment of the Secured Lender is neither fair nor equitable.

3.8 The Amended Plan Discriminates Unfairly In Violation Of Bankruptcy Code § 1129(b)(1).

In addition to the foregoing, the Amended Plan discriminates unfairly in favor of the Class 3A trade claims, and in favor of the Amresco secured claim (Class 2-0).

"The recognition that a deficiency claim is entitled to the same treatment as all other unsecured claims under the debtor's plan would be undermined if the debtor was permitted to classify separately such deficiency claims. ***The debtor may not ignore the rejection of its plan by the holder of a large unsecured deficiency claim simply because the debtor designated a specially preferred separate class of easily created trade creditors whose acceptances may be readily obtainable by offering them more than the disfavored deficiency claim holder. Manifestly such treatment of unsecured claims is unfairly discriminatory*** within the meaning of 11 U.S.C. § 1129(b)(1)." *In re Pine Lake Village Apartment Co.*, 19 B.R. 819, 831 (Bankr. S.D.N.Y. 1982) (emphasis added).

Further, a debtor's plan that discriminates unfairly against a secured creditor's deficiency claim and in favor of other unsecured creditors, can not be confirmed where the plan provides that other unsecured claims will be paid in full on the effective date of the plan but the bulk of the secured creditor's claim, including its deficiency, claim will not be paid for a number of years. *In re Cherry Hill Associates Limited Partnership*, 150 B.R. 289 (Bankr. D. Mass. 1993).

Clearly the Amended Plan unfairly discriminates against both the Secured Lender's Class 3B Claim and Secured Claim. Under the Amended Plan there is a de facto subordination of the unsecured claims of the Secured Lender to the other unsecured creditors. The Class 3A unsecured trade creditors will share in operational cash flows after the interest only payments are made on the secured debt, and Secured Lender's unsecured Class 3B claim won't be paid anything until the Class 3A claims are paid in full, with interest. In addition, even assuming the Secured Lender has to pay a preference amount back, it also does not get to participate in the

Preference Recovery Pool until the unsecured claims in Classes 3D and 3E are paid in full. This is simply nonsensical.

As for the Secured Lender's secured claim, Amresco gets paid in full within 2 years of the Effective Date, at a higher interest rate than the Secured Lender. The Debtor does this despite that its own amortization schedule subjects the Secured Lender's secured claim to interest only for two years, with a ten percent reduction of principal over seven years, and a 90% balloon payment at the end of seven years, all of which will be paid at a lower interest rate than the Amresco claim. This methodology goes against every basic tenet of finance, and in so doing unfairly discriminates against the Secured Lender.

3.9 The Amended Plan Does Not Meet The Cramdown Requirements Of Bankruptcy Code s § 1129(B)(2) As To The Class 2N Secured Claims.

Bankruptcy Code § 1129(b) provides in pertinent part as follows:

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a Class includes the following requirements:
>
> (A) With respect to a class of secured claims the plan provides –
>
> (ii) for the sale, subject to Section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) and (iii) of this subparagraph. . . .

Bankruptcy Code § 1129(b)(2)(A)(i)(I) (II), (ii) (emphasis supplied).

This Amended Plan fails to meet the cramdown tests for either § 1129(b)(2)(A)(i) or (ii).

(a) The Amended Plan Impermissibly Fails To Account For The Secured Lender's Cash Collateral.

The Ninth Circuit has held that the value of a secured creditor's claim, for the purposes of confirmation, includes the market value of the real property plus the amount

of the accumulated cash collateral. *See In re Ambanc La Mesa Ltd. Partnership*, 115 F.3d at 654.

To date the Debtor has failed to disclose to the Secured Lender, by Class Claim, how much cash collateral is held per hotel. The Amended Plan must ensure that the Secured Lender's Allowed Secured Claims include the amount of the cash collateral attributable to each corresponding hotel. The Debtor's Amended Plan fails to provide for either of these requirements.

(b) The Amended Plan Impermissibly Voids The Secured Lender's Second Lien Position For Its Class 2N-1 And 2N-5 Claims.

The Secured Lender is oversecured as to its first lien positions on its Class 2N-1 (Abilene Holiday) and Class 2N-5 (Leavenworth) Claims. As such, the Secured Lender's second lien claims (securing the cross guarantees) are allowed under Bankruptcy Code § 506 (up to the value of those hotels). The provisions of the Amended Plan giving Best Inns a second lien on the Abilene Holiday Inn and Leavenworth Hotels constitutes a *de facto* avoidance of the Secured Lender's second liens on those hotels in violation of controlling case authority. *See In re Commercial Western Finance Corp.*, 761 F.2d 1329 (9th Cir. 1985). It also violates the cramdown provisions of Bankruptcy Code § 1129(b)(2)(A) by not preserving the Secured Lender's second lien on those two hotels.

(c) The Amended Plan's Amortization, Interest Rate, And Balloon Payment Feature Do Not Give The Class 2N Secured Claims The Present Value Of Their Claims.

The Ninth Circuit has adopted a case-by-case "market" approach to determine the appropriate interest rate in the event of a cram down. In determining the appropriate interest rate the court must consider the prevailing market rate for a loan taking into

consideration the length of the term, quality of the security interest, and risk of default. *See In re John Fowler*, 903 F.2d 694, 697 (9th Cir. 1990).

Cases requiring a market rate of interest have considered factors from among the following in determining the risk: 1) the quality of the security; 2) the loan to value ratio; 3) the feasibility of the plan; 4) anticipated collection cost; 5) the amount of collateral; 6) duration of the loan; 7) risk of default; 8) the credit standing of the borrower; 9) the terms of the loan; and 10) the existence of a guarantor. *See In re Sherwood Square Associates*, 107 B.R. 872, 884 (Bankr. D. Md. 1989).

Under the Amended Plan the Debtor is asking to retain the current non-default contract rate contained in the Secured Lender's original loan documents (to which this Debtor was not a party—indeed, this Debtor did not even exist as an entity when these loans were made). What the Debtor seems to fail to realize is that the circumstances and conditions that were taken into consideration to determine the contract rate under the original loan agreements have changed materially—and changed for the worse. It should go without saying that the risk to the Secured Lender is significantly greater than at the time the Secured Lender originally extended funding for the Retained Hotels.

Under the Amended Plan the Debtor will have no capital at risk in the project, the quality of the collateral is diminishing, there is a loan to value ratio over 100%, the current earning capacity of the Retained Hotels is suspect at best, and finally by the Debtor's own calculations there will be over a 90% remaining principal balance at the end of the term with no identified source of repayment.

Clearly the contract rate is too low to provide the Secured Lender with the present value of its claim. Given the number of risk factors and size of the claim, the appropriate interest rate would need to be much higher.

(d) The Amended Plan's Release Provisions Fail To Preserve The Secured Lender's Credit Bid Rights Under Bankruptcy Code § 363(k).

As previously discussed in paragraph 3.2 above, § 363(k) allows a lienholder to bid up to the entire amount of the lien when a sale of property out of the ordinary course of business is proposed. By being allowed to credit bid under § 363(k), the Secured Lender would be able to protect the amount of its lien in essentially the same manner as allowed under the provisions of § 1111 of the Bankruptcy Code. Section 363(k) reads:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

Subsection (b) of § 363 provides for the sale of estate property, other than in the ordinary course of business, after a notice and hearing.

The Secured Lender's right to credit bid under § 363(k) is set forth in § 1129(b)(2)(A)(ii), which requires that with respect to a class of secured claims, the plan must provide:

> for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; as set forth in § 1111(b)(1)(A).

The Courts have held that when a debtor, through its plan of reorganization, seeks to reduce the amount of its debt over time while retaining an interest in future profits arising from any subsequent sale of the estate's property, that future interest is clearly a valuable right and, thus, the actual value of the subject property is unclear. As such, "fairness requires that the [secured creditor], be allowed the full amount of any value in

the property. Allowing the secured creditor to credit bid under § 363(k) …protect[s] the [secured creditor's] interest in the full value of the property." *See, In re California Hancock, Inc.,* 88 B.R. 226 (9th Cir. BAP 1988). A Chapter 11 plan purporting to take away the secured creditor's right to credit bid can not be confirmed under the cramdown section that demands the fulfillment of the "fair and equitable" requirement. *See In re Monarch Beach Venture, Ltd.,* 166 B.R. 428, 433 (Bankr. C.D. Cal. 1993).

In the instant case, at any time after the effective date (assumed to be June, 2000), the Reorganized Debtor will have the right to sell any of the Retained Hotels. The Secured Creditor will not have any ability to credit bid its secured claims under Bankruptcy Code § 363(k). *See* Amended Plan at 15:9-12. Clearly this Debtor, similar to the debtor in *California Hancock,* is hoping to retain an interest in the future profits arising from any subsequent sale of the Retained Hotels. That future interest is clearly a valuable right and, thus, the actual value of the Retained Hotels is unclear. As such, paraphrasing the Ninth Circuit BAP, "fairness requires that the Secured Lender, be allowed the full amount of any value in the Retained Hotels." In short, the Secured Lender must be given the right to credit bid.

Without allowing the Secured Lender the right to credit bid in a proposed "sale" of the property pursuant to a plan of reorganization, the Court cannot properly determine that the Debtor's proposed plan of reorganization can be confirmed.

3.10 <u>The Amended Plan Does Not Meet The Cramdown Requirements As To The Secured Lender's Class 3B Unsecured Claim And Violates The Absolute Priority Rule</u>.

Bankruptcy Code § 1129(b) provides in pertinent part as follows:

> (2) For purposes of [§ 1129(b)], the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> * * *

> [B] With respect to a class of unsecured claims – (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim of a value, as of the effective date of the plan, exceed to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan or account of such junior claim or interest any property.

Bankruptcy Code § 1129(b)(2)(B).

The Secured Lender's Class 3B Unsecured Claim has rejected the Amended Plan. The existing equityholders (Class 4) "shall retain their interests" in the Debtor. *See* Amended Plan at 13.

In order for this to happen over the rejection of Class 3B, the Class 3B claim must be paid in full. The Amended Plan is unconfirmable as it fails to comply with Bankruptcy Code § 1129(b)(2)(B).

(a) <u>The Interest Rate Given Does Not Provide The Present Value Of The Class 3B Claim</u>.

Applying the same case law as, and for all of the reasons cited above in, paragraph 3.9(b), the Amended Plan's proposed interest rate of the lower of 6% or the federal judgment rate is woefully insufficient. First, the Class 3B debt is unsecured, which by itself under normal industry standards requires a higher interest rate than secured debt. Second, the risk of non-payment is extremely high in light of the fact that the Secured Lender's claim is subject to *de facto* subordination to other unsecured claims, the Best Inns "capital" loan will be secured and paid prior to the payment of the Secured Lender's Class 3B Claim, and the final payment of the $1.5 million (by the Debtor's own numbers) of the Class 3B Claim is subject to a seven year balloon payment from an unidentified purchaser or refinancier.

The totality of these factors requires that the Secured Lender's Class 3B claim be provided a greater interest rate than even the Class 2N secured claims in order to ensure an adequate present value calculation.

(b) <u>The "Balloon Payment" Feature Does Not Provide Present Value</u>.

When the payment of an unsecured claim is subject to a balloon payment, the present value of the stream of payments promised to the creditor on account of its deficiency claim is subject to a significant discount. *See In re Cranberry Hill Associates Limited Partnership,* 150 B.R. 289, 291 (Bankr. D. Mass. 1993). In that case, the Debtor's plan proposed to repay a secured creditor's deficiency claim of $2,762,000.00 over a nine year period, at $7,000.00 per month, with a balloon payment of at least $2,000,000.00 which was the balance to be paid at the end of the nine years. The court found that because the bulk of the secured creditor's claim would not be paid for nine years, the present value of the stream of payments promised to the secured creditor on account of its deficiency claim "is in the range of fifty percent of the claim." The court noted that when the value of the underlying collateral is used to provide payment for the deficiency claim, to the extent that the property failed to appreciate, the secured creditor would go unpaid. Therefore, the secured creditor would not get full present value and its claim would be subject to " much higher risk of nonpayment.").

Here the Amended Plan calls for paying $1.5 million (almost 50%) of the Secured Lender's Class 3B Claim in the form of a seven-year balloon payment. And in so doing the Debtor is relying on under-performing and depreciating hotels to make good on that payment. Yet, the Debtor only wants to pay a minimal amount of interest for this extremely risky endeavor. By doing so the Debtor fails to provide for the present value of the Secured Lender's Claim.

(c) Even If The Debtor Attempts To Rely On The "New Value" Exception To The Absolute Priority Rule, The Amended Plan Is Fatally Deficient.

(i) The Debtor Is Not Exposing The Deal To The Marketplace.

The Supreme Court has found that, "it would be a fatal flaw if old equity acquired or retained the property interest without paying full value. It would thus be necessary for old equity to demonstrate its payment of top dollar . . . [and] the best way to determine value is exposure to the market." *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 457 (1999).

Under the Amended Plan the existing equity holders are retaining their interests in the Retained Hotels without any personal liability or risk in the event of default. Nonetheless, under the Amended Plan Mr. Kilburg (who controls all the partners of this Debtor) gets the benefit of controlling the Retained Hotels with an above market management contract that benefits no one but Mr. Kilburg and his wholly owned management company. Yet, rather than expose the Retained Hotels to a competitive market he seeks to hold the Retained Hotels and the Secured Lender captive to satisfy his own personal goals.

This is exactly the scenario that the Supreme Court ruled against in *203 North LaSalle*. An old equity holder can no longer have a strangle-hold on the estate until its creditors cry for mercy. By not exposing the Retained Hotels to the market, the Amended Plan violates the absolute priority rule.

(ii) The "Capital Infusion" Does Not Satisfy The "New Cash" Requirement. The so-called "capital infusion" is not only a loan, but a secured loan. Moreover, the capital infusion is not coming from any of the existing

partners—it is a "signing payment" made *to the Debtor*, earmarked for signage and other changes only to the six hotels to be reflagged. Kilburg Hotels is only guaranteeing the repayment.

While the Ninth Circuit holds that "the new value exception remains a vital principle of bankruptcy law." *See Bonner Mall Partnership v. U.S. Bancorp Mortgage Co.,* 2 F.3d 899 (9th Cir.1993), its opinion on the continued viability of the new value exception hinges on its interpretation of the absolute priority rule.

The Ninth Circuit has held that a proposed plan of reorganization will not violate the absolute priority rule if that plan satisfies all requirements for the new value exception — former equity owners are required to offer value that is new, substantial, money or money's worth, necessary for successful reorganization, and reasonably equivalent to the value or interest received. *Id.* at 908. When evaluating whether a reorganization plan satisfies the requirements of the new value exception to the absolute priority rule, the court is determining whether old equity is unjustifiably attempting to retain its corporate ownership powers in violation of the absolute priority rule or whether there is a genuine and fair exchange of new capital for an equity interest. *Id.* at 909. In this case, the Amended Plan is fatally deficient for at least two (2) reasons:

The Best Inns loan is not new money. Under the Amended Plan the Debtor is proffering that the loan it will receive from Best Inns should be characterized as a form of "capital contribution," or "new money," Best Inns is extending this loan in order to reflag some of the Retained Hotels and bring them within its specifications as a franchisor. The Best Inns loan will be secured by a junior lien that is subject to repayment. Under the Amended Plan, repayment of

the Best Inns loan will occur ahead of the deficiency claim of the Secured Lender and ahead of the Secured Lender's second position liens on certain hotels. In using the Best Inns loan as a "capital contribution" ultimately the Debtor will have no capital at risk, thereby shifting the entire risk to the secured creditors.

At least one court has held that when "it is the reorganized debtor that will be repaying the borrowing and not the shareholders . . . it cannot be said that the shareholders are making a capital contribution. They are in no way at risk. Therefore, . . . the borrowing by a reorganized debtor cannot be considered a capital contribution by its shareholders." *In re Sawmill Hydraulics, Inc.*, 72 B.R. 454, 457 (Bankr. C.D. Ill. 1987). In that case, the debtor's plan of reorganization provided for a capital contribution through certain shareholders working for below normal wages and the reorganized debtor incurring additional bank debt of $50,000. The plan further provided for the pre-petition shareholders to continue as shareholders in the reorganized debtor with unsecured creditors being paid 25% of their claims. One unsecured creditor holding a $300,000 claim objected to confirmation of the plan arguing in part that the plan as proposed was not fair and equitable and unfairly discriminated against the unsecured creditors as to the debtor's shareholders retaining their interest without payment in full of all senior interests. The Court refused confirmation.

Kilburg Hotels' guarantee is not "new money." It is clear that none of the limited or general partners of the Debtor are directly infusing any money (new or otherwise) into the Debtor. The closest any of them come is Kilburg Hotels (the general partner) guaranteeing the Best Inns loan. The Ninth Circuit has

stated very clearly in *In re Ambanc La Mesa Limited Partnership*, 115 F.3d 650, 654-655 (9th Cir. 1996):

> ***The relevant amount for the substantiality analysis is the partner's up front contribution.*** Under the "money or money's worth" requirement, the new capital contribution by the former equity holders (1) must consist of money or property which is freely traded in the economy, and (2) must be a present contribution, taking place on the effective date of the Plan rather than a future contribution. *See In re Yasparro*, 100 B.R. 91, 96-97 (Bankr. M.D. Fla. 1989) (holding that promissory notes from the individual debtor to the unsecured creditors were future rather than present contributions and thus did not satisfy the new value corollary) (citing *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S. Ct. 963, 99 L. Ed. 2nd 169 (1988); *In re Stegall*, 85 B.R. 510 (C.D. Ill. 1987), *aff'd.*, 865 F.2d 140 (7th Cir. 1989)). ***Only those contributions from Ambanc's partners that will actually be paid on the effective date of the plan may be considered as money or money's worth under the new value corollary….***

(emphasis supplied).[15]

A guaranty of a loan to the Debtor is not an "up front" capital infusion by anyone, much less the equity holders in the Debtor. *See In re Kham & Nate's Shoes No. 2, Inc.*, 908 F.2d 1351, 1361 (7th Cir. 1990) ("Guaranties [by old equity] are no different [than promises of future labor]. They are intangible, inalienable, and unenforceable…. The [old equityholders] may revoke their guarantees or render them valueless by disposing of their assets…. Guarantees have 'no place in the asset column' of a balance sheet").

This particular "guarantee" is even less of a contribution, as it is both secured by the reorganized Debtor's assets and given by a shell company with no tangible assets. The Amended Plan is the pinnacle of *chutzpah*—it is a "new value" plan that is a leveraged buyout! When taken in conjunction with the fact

that this Debtor acquired its ownership interests in the various hotels it now owns for no out-of-pocket, at-risk capital (and indeed Mr. Kilburg himself acquired his interest in all of the Prior Partnerships that owned these hotels for no out-of-pocket, at-risk capital), it is apparent that this Debtor is seeking to perpetuate a continued retention of ownership interests and assets in which it will not currently have, nor did it ever have, any out-of-pocket, at-risk equity.

(iii) The Retained Equity Interests Have Value. The Debtor will assert that the Class 4 retained partnership interests have no value because they are entitled to no distributions until the creditors are paid. This is specious.

The value they have, however, is the ability to direct the management contract to an insider, who will receive over $3 million in management and accounting fees. At its essence, Mr. Kilburg has the exclusive ability to hire himself as manager of the Retained Hotels. This is real and tangible value.

Courts have consistently held that any "no value" theory is without merit. The overwhelming consensus of authority has found that "***whether the value is present or prospective, for dividends or only for purposes of control*** a retained equity interest is a property interest to which the creditors are entitled before the stockholders can retain it for ***any*** purpose." *In re Drimmel*, 108 B.R. 284, 288 (Bankr. D. Kan. 1989) (emphasis added), *citing Northern Pacific Rail Co. v. Boyd*, 228 U.S. 482, 508 (1913).

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[15] The contrived nature of the so-called "capital infusion" in this case is precisely the sort of thing that the Bankruptcy Court was concerned with in *In re Tallahassee Associates, LP*, 132 B.R. 712, 717 (Bankr. W.D. Pa. 1991) when it stated:

> A rigorous showing as to these [new value] requirements is necessary in order to ensure that a debtor's equity holders do not eviscerate the absolute priority rule by means of a contrived infusion.

IV. CONCLUSION AND RELIEF REQUESTED.

For all the foregoing reasons, the Secured Lender respectfully requests that the Court deny confirmation of the Amended Plan.

RESPECTFULLY SUBMITTED this 28th day of April, 2000.

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